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UNCITRAL Working Group III: Security for Costs – An Inefficient Mechanism to Avert Frivolous Claims in ISDS

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Ahead of the thirty-ninth session of UNCITRAL Working Group III (Investor-State Dispute Settlement Reform), the General Assembly Secretariat issued a note on issues to be considered on the topic of security for costs and frivolous claims. Averting frivolous claims has been a recurring topic in the ISDS debate over the past years, not least in the UNCITRAL reform work. The existing concerns are prompted by the fact that States involved in ISDS have testified to frivolous actions from investors being a relatively common occurrence. In addition, States have often found it difficult to obtain reimbursement for their legal fees in case of a successful outcome of the case.

These testimonies are demonstrative of an apparent desire of states involved in ISDS to increase the available remedies against investor-induced frivolous measures. Security for costs has, in many instances, including in the UNCITRAL reform process, been discussed as a mechanism that can be used for the purpose of reducing the risks associated with frivolous claims. However, ISDS practice shows that arbitral tribunals (both under the auspices of the UNCITRAL and ICSID framework) have thus far applied a high standard for granting security for costs. Against this background, one topic for the (now deferred) thirty-ninth session will be "*to consider whether work should aim at providing a more predictable framework for security for costs and in that context,* […] *the conditions to be satisfied in order for the parties to request, and for the tribunal to order, security for costs*."

While the issue of frivolous actions by investors and limited costs recovery for the states is by now a well-known concern, any reform of the standards for ordering security for costs must carefully address the conflict between the interest of adequate costs recovery for States, and policy considerations relating to the interest of not stifling legitimate claims brought by underfinanced investors. Added to this, any *prima facie* assessment of the frivolousness of a claim exposes arbitral tribunals to the risk of allegations that they have prejudged the case. The restrictive approach taken by arbitral tribunals in deciding applications for security for costs appears to arise out of legitimate policy considerations, and gives rise to the question of whether security for costs – even if subject to loosened standards – can work as an efficient mechanism for averting frivolous claims.

Legitimate interests explain the restrictive approach taken by ISDS tribunals with respect to security for costs in practice

So far, UNCITRAL practice (and ISDS practice at large) has shown that arbitral tribunals in investor-state arbitration have subjected security for costs orders to a high standard.

For example, in *Guarachi v. Bolivia*, the respondent relied upon the existence of third-party funding on the investor's side as well as evidence that the investor had no real assets in support of a request for security for costs. The arbitral tribunal rejected the reasons invoked by Bolivia as insufficient for demonstrating that the investor would be unable to cover an adverse costs award. The tribunal underlined that an "order for posting of security for costs remains a very rare and exceptional measure".

Similarly, in *SAS v. Bolivia*, the investor was a Bermuda shell company with no assets or economic activity. Bolivia filed a request for security for costs in the amount of USD 2.5 million. The arbitral tribunal rejected the request and noted, amongst other things, that:

> "In relation to the necessity and the urgency of the measure, investment arbitration tribunals considering requests for security for costs have emphasized that they may only exercise this power where there are extreme and exceptional circumstances that prove a high real economic risk for the respondent and/or that there is bad faith on the part from whom the security for costs is requested."[1)]

The tribunal further reasoned that: "[i]n sum, the general position of investment tribunals in cases deciding on security for costs is that the lack of assets, the impossibility to show available economic resources, or the existence of economic risk or difficulties that affect the finances of a company are not *per se* reasons or justifications sufficient to warrant security for costs." The restrictive view is further elucidated by the fact that there are few ISDS cases in which security for costs has in fact been granted.[2)]

It is conceivable that a loosening of the standards for ordering security for costs under the UNCITRAL framework may increase the inclination of arbitrators to grant security for costs. However, any reform must factor in the legitimate reasons that lay at the foundation of the restrictive approach demonstrated in international practice thus far.

In the authors' view, the main explanation for the restrictiveness upheld in international practice is two-fold. First and foremost, it relates to access to justice concerns. Such concerns are triggered by the invasive nature of security for costs as compared to other kinds of provisional relief. Generally, compelling (under the threat of dismissal) a party with limited resources to post security for costs at the outset or during an arbitral proceeding restrains the party's ability to present its case and may even stifle the party's substantive claims altogether. Thus, security for costs orders may interfere with a party's access to justice insofar as the party lacks financial means to comply with the security for costs order and thus is denied the opportunity to be heard.[3)] Consequently, from a policy perspective, it is desirable that arbitral tribunals retain their inclination to carefully balance the right of a party to pursue its claim against the right of an opposing party to recover its costs.

Secondly, assessing the merits of the claimant's claim in investor-state arbitration often involves complex issues of both a jurisdictional and substantive nature. These matters are often difficult (if not impossible) to evaluate in any depth during the early stages of the proceedings. This is

illustrated in, among other cases, *SAS v. Bolivia* where the tribunal concluded that it could not grant security for costs merely on the ground that SAS was used by the "real investor" to bring a claim. Doing so, the tribunal stated, would constitute a prejudgment on a crucial jurisdictional issue, "on which Parties' submissions are pending". Arguably, the fear of prejudging crucial issues constitutes a significant contributing factor which explains the hesitance of arbitrators to grant an order for security for costs in general.

The reasons for upholding fairly strict standards limits the utility of security for costs as a mechanism for averting frivolous claims and calls for a more holistic approach

It is clear that the occurrence of frivolous actions in investor-state arbitration constitutes a serious concern, particularly in light of the fact that states often times are not in a position to obtain any costs recovery in case of a successful outcome. These concerns arguably justify a loosening of the so far very strict requirements that have generally applied in ISDS practice. Nevertheless, the fact that the restrictive approach adopted by arbitral tribunals stems from legitimate policy considerations sets a limit for how extensive any reform of the applicable standards can be. Moreover, loosening the standards with respect to granting security for costs does not adequately address the second policy concern – that tribunals wish to avoid prejudging the merits of the case in assessing a potentially frivolous claim.

These reasons entail that the situations in which security for costs may be a viable alternative for averting frivolous claims should (and likely will) remain limited to situations where there is a clear case of frivolousness combined with a demonstrable inability to comply with an adverse cost decision. This in turn, gives reason to question security for costs as a sufficiently efficient mechanism for averting frivolous claims. Accordingly, dealing with frivolous action in investor-state arbitration under the UNICTRAL framework arguably requires a more holistic approach.

In this regard, it is interesting to note that the UNCITRAL WG III, following the initiative of the ICSID reform process, is currently considering adoption of an expedited procedure for addressing unmeritorious claims. In essence, introducing such a procedure would aim to enable the dismissal of claims that manifestly lack legal merit at an early stage of the proceedings, before they unnecessarily consume the parties' resources. In the authors' view, such an expedited procedure may, if implemented, become a viable alternative (in addition to security for costs) for addressing the issue of frivolous claims. To enable any such procedure to become a useful option, it is key that the employed framework clearly sets out when and under what circumstances the rules may come into play. Moreover, in light of access to justice concerns, it is important that the expedited procedure is designed so that it to requires the State to clearly demonstrate that the claim is frivolous,[4)] while still taking due consideration to cost efficiency concerns (limiting, for instance, rounds of written submissions to a minimum). Additionally, the framework should provide for cost allocation mechanisms enabling an adequate risk distribution between the state and the investor, particularly in the event of a decision in favor of the investor.

Concluding remarks

The thirty-ninth session of the UNCITRAL Working Group III is likely to have significant impact

on the standing of security for costs as a mechanism for addressing frivolous claims brought by investors in UNCITRAL arbitration going forward. While a loosening of the strict standards for granting security for costs so far applied by tribunals in practice may be warranted, legitimate policy considerations sets an outer boundary on how extensive any such revision can be. For this reason, it is desirable that the issue is addressed using a holistic approach, with due regard to the limited utility of security for costs as means for averting frivolous claims in ISDS.

To see our full series of posts on the UNCITRAL WG III reform process, click here.

References

?1 Para. 59.

In this context, it should, however, be noted that despite the many instances where arbitral tribunals have entertained a very restrictive approach, there are also recent examples of ISDS tribunals engaging in slightly less strict approach. One such example is Caso CPA No. 2016-08 Manuel Garcia Armas v. Venezuela, Procedural Order No. 9 (20 Jun. 2018). In this case, the arbitral
?2 tribunal found that the investor in general had indicated that it possessed a limited ability to cover adverse costs (merely five out of nine claimants had demonstrated any proof of solvency). The arbitral tribunal concluded that this, in combination with the fact that it had been shown that the investor's third-party funder had not committed to cover adverse costs, was sufficient to order security for costs in the amount of USD 1.5 million.

?3 *Cf.* Born G, *International commercial arbitration*, Second edition (2014), p. 2496.

?4 *Cf.* ICISD Arbitration Rule 41(5), which requires the party requesting for dismissal to specify, "as precisely as possible", the basis on which the claim is "manifestly without legal merit".

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